

# THE PUZZLE OF “FREEDOM OF CONTRACT” IN CHINA’S CONTRACT LAW

*Jun Zhao\**

I.	INTRODUCTION.....	106
II.	THEORETICAL FOUNDATION .....	106
	A. <i>Evolution of China’s Contract Law</i> .....	106
	1. China’s Contract Practice and Law in the Era of Central Planning.....	106
	a. <i>The Meaning of “Central Planning” and Its Implication</i> .....	106
	b. <i>Reflection of Central Planning on Contracts</i> .....	107
	c. <i>From Three Contract Laws to A Unified Contract Law</i> .....	108
	2. The Significance for China of Adopting the Principle of “Freedom of Contract” .....	109
	3. The Definition and Incidence of “Freedom of Contract” in Current Contract Law of China.....	110
	a. <i>The Chinese Version of “Freedom of Contract”</i> .....	110
	b. <i>The Emphasis When Implementing Freedom of Contract in Different Stages of Contracting</i> .....	111
	B. <i>Comments on the Rise and Fall of Freedom of Contract in Western Legal Thoughts</i> .....	111
III.	A COMPARISON OF THE RATIONALES BEHIND U.S. AND CHINA’S CONTRACT LAWS .....	113
	A. <i>Ideological Level: Paternalism v. Contractualism</i> .....	113
	B. <i>Institutional Level: Rules v. Standards</i> .....	115
VI.	LIMITATIONS ON THE “FREEDOM OF CONTRACT” .....	116
	A. <i>A Preliminary but Fundamental Issue</i> .....	116
	B. <i>Overarching Limitations on “Freedom of Contract”</i> .....	117
	1. The Obligation to Act in Good Faith .....	117
	2. The Obligation Not to Offend Public Order and Good Morals .....	119
	C. <i>Various Specific Limitations on “Freedom of Contract”</i> .....	120
	1. Administrative Approval and Supervision.....	120

---

\* Lecturer, Guanghua Law School, Zhejiang University. J.D., Cornell Law School; LL.M., Harvard Law School; LL.B., Zhejiang University. For insightful comments across several drafts, I thank William P. Alford, John C. Reitz, Gu Zhang, Timothy Webster, Martin Gelter and Hongdao Qian. I gratefully acknowledge financial support provided by the Department of Education of Zhejiang Province (Grant No. Y200906638) and by the Special Research Fund for the “Morning Star Project” through Faculty of Social Sciences, Zhejiang University.

2. Special Care for Vulnerable Parties ..... 121  
 V. OTHER OPTIONS FOR CONTRACT LAW ..... 123  
 VI. CONCLUSION ..... 125

I. INTRODUCTION

Recent events have intensified the debates over “freedom of contract” and governmental intervention in China: the Shanxi coal mining reform and the forced mergers, the corkage fee dispute in Guizhou, the offers posted on the Internet selling human milk, contractual surrogacy arrangement, contractually designed money laundering scam in western China under the name of western China development, just to name a few.

By studying the evolution of China’s contract law and providing a comparison with the western notion of “freedom of contract,” this article relies on both U.S. and Chinese frameworks in addressing these questions. This article examines several challenges toward China’s contract law and the trends of “freedom of contract.” These issues are discussed in the setting of China’s special cultural, legal, economic, and political circumstances, including both formal and informal institutions. The article concludes by providing normative recommendations on how to reconcile “freedom of contract” with the current contract law.

II. THEORETICAL FOUNDATION

*A. Evolution of China’s Contract Law*

1. China’s Contract Practice and Law in the Era of Central Planning

As one can only understand the functions of a law through the understanding of the social and economic background, this article first studies the political and economic background of China’s contract law.

*a. The Meaning of “Central Planning” and Its Implication*

A centrally planned economy was one of the most significant characteristics of China’s previous economy form, under which economic units were expected to create a plan for their activities and coordinate with

the government to provide resources to achieve the goals under the plan.<sup>1</sup> Prompted by dissatisfaction with the results of the traditional system of collective agriculture and planned industry and commerce,<sup>2</sup> China began a major program of economic reform.<sup>3</sup>

*b. Reflection of Central Planning on Contracts*

Under the central planning framework, contracts were essentially administrative devices. The state plans need to be fulfilled and put into practice by bringing suppliers and customers together. Under these arrangements, people are forced to enter into transfers as the transfers have already been arranged according to the state plan. The nature of contracts is mandatory under these arrangements.<sup>4</sup> Specifically, in a planned economy, contracts are expected to guarantee the fulfillment of the state plan, test the state plan to see if it is correctly made, and provide information for the state accordingly.<sup>5</sup> In practice, most industrial and wholesale contracts were entered into at goods-ordering conferences attended by those who would produce and deliver products under the plan. At these conferences, instead of having parties negotiate the agreements by themselves, ministries would assign the matching parties, and even influence the terms of the resulting agreements.<sup>6</sup>

---

1. For detailed discussions about China's previous centrally planned economy as well as the reform towards market economy, see, e.g., John McMillan & Barry Naughton, *How to Reform a Planned Economy: Lessons from China*, 8 OXFORD REV. ECON. POL'Y 459, 460 (1992); Lucie Cheng & Arthur Rosett, *Contract with a Chinese Face: Socially Embedded Factors in Transformation from Hierarchy to Market, 1978–1989*, 5 J. CHINESE L. 143, 229 (1991).

2. See Jan S. Prybyla, *Economic Reform of Socialism: The Dengist Course in China*, 507 ANNALS AM. ACAD. POL. & SOC. SCI. 113, 117 (1990) (explaining that the need to reform the Chinese economy arose from the economy's serious quality problems: chronic shortages, waste, low factor productivity and technological backwardness).

3. The period of reform coincided with the period of legalization. See, e.g., Benjamin L. Liebman, *Assessing China's Legal Reforms*, 23 COLUM. J. ASIAN L. 17, 28 (2009); Pitman B. Potter, *Legal Reform in China: Institutions, Culture, and Selective Adaptation*, 29 LAW & SOC. INQUIRY 465, 465 (2004); Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 57 (2005).

4. See, e.g., Lucie Cheng & Arthur Rosett, *Contract with a Chinese Face: Socially Embedded Factors in Transformation from Hierarchy to Market, 1978–1989*, 5 J. CHINESE L. 143, 192 (1991). As the authors insightfully pointed out, those "contracts" were not the product of the parties' agreement or exchange and were of only limited significance in defining performance obligations.

5. See, e.g., David A. Hayden, *The Role of Contract Law in Developing the Chinese Legal Culture*, 10 HASTINGS INT'L & COMP. L. REV. 571, 572 (1987).

6. See generally RICHARD M. PFEFFER, UNDERSTANDING BUSINESS CONTRACTS IN CHINA 1949–1963 18 (Harvard University Press 1973); WANG LIMING & CUI JIANYUAN, HETONGFA XINLUN [NEW DISCUSSIONS ON CONTRACT LAW] 91 (2000).

*c. From Three Contract Laws to A Unified Contract Law*

Paralleling the special meaning and function of contracts in China, the pertinent contract laws also had special characteristics and served special functions.<sup>7</sup> Between 1979 and 1999, instead of having a general system of contract law to govern all contracts, a few distinct sets of contract rules had been established.<sup>8</sup> In the 1980s, China adopted the Economic Contract Law,<sup>9</sup> Foreign Economic Contract Law,<sup>10</sup> General Principles of Civil Law,<sup>11</sup> and Technology Contract Law,<sup>12</sup> respectively. These major pieces of law, together with other administrative regulations and judicial interpretations, formed the entire framework for contract law.<sup>13</sup> In addition, China acceded to the United Nations Convention on Contracts for the International Sale of Goods in 1988.<sup>14</sup>

The adoption of the Contract Law of the People's Republic of China (Contract Law) in March 1999 was deemed as one of the pivotal achievements in China's legal reform to accommodate the emerging market economy because the Contract Law reduced state intervention to the minimum level, demonstrating that contracts are no longer deemed as vehicles of carrying out the state economic plan.<sup>15</sup>

---

7. For an overview of the evolution of China's contract laws, see Feng Chen, *The New Era of Chinese Contract Law: History, Development and A Comparative Analysis*, 27 *BROOK. J. INT'L L.* 153, 153 (2001).

8. WANG LIMING & CUI JIANYUAN, *HETONGFA XINLUN* [NEW DISCUSSIONS ON CONTRACT LAW] 90 (2000).

9. *Id.* Adopted in 1981.

10. *Id.* Adopted in 1985.

11. *Id.* Adopted in 1986.

12. *Id.* Adopted in 1987.

13. See Zhou Jianhua & Yu Guanghua, *China's Uniform Contract Law: Progress and Problems*, 17 *UCLA PAC. BASIN L.J.* 1, 4 (1999).

14. See Friedrich Blase, *CISG and China—An Intercontinental Exchange*, 4 *VINDOBONA J. OF INT'L COM. L. & ARB.* 95, 95 (2000) (discussing the Convention's influence on the development of China's contract law).

15. See Mo Zhang, *Freedom of Contract with Chinese Legal Characteristics: A Closer Look at China's New Contract Law*, 14 *TEMP. INT'L & COMP. L. J.* 237, 237 (2000). See also Jiang Ping et al., *Lun Xin Hetongfa Zhongde Hetong Ziyou Yuanze yu Chengshi Xinyong Yuanze* [On the Principles of Freedom of Contract and Good Faith in the New Contract Law], 1 *TRIB. POL. SCI. & L.* 2, 3-7 (1999); Zhou Jianhua & Yu Guanghua, *China's Uniform Contract Law: Progress and Problems*, 17 *UCLA PAC. BASIN L.J.* 1, 2 (1999).

## 2. The Significance for China of Adopting the Principle of “Freedom of Contract”

In the United States, as one of the cornerstones of private law, “freedom of contract”<sup>16</sup> in the contemporary period has undergone considerable erosions and restrictions due to such factors as the increased use of standard contracts and the mandatory economic regulation by the government.<sup>17</sup> However, in a transition economy,<sup>18</sup> “freedom of contract” was relatively new in China and it must be promoted as a central principle of contract law.<sup>19</sup> Another compelling reason to adopt the principle of “freedom of contract” lies in the need to foster transactions.<sup>20</sup> In fact, “freedom of contract” is both a requirement of the market economy as well as an impetus for the same.<sup>21</sup> With the development of a market economy, many scholars have argued that parties in a market economy should have the autonomy and freedom to decide on the transactions they enter. It is only through transactions based on free decisions of the parties that the economic and social resources will be allocated efficiently and effectively through market mechanism.<sup>22</sup> Contracts create wealth, allocate risks and resources, and also constitute one of the fundamental institutions that underpin the market system.<sup>23</sup> Contracts typically are efficient in the

---

16. “Freedom of contract” is a judicial concept that contracts are based on mutual agreement and free choice, and thus should not be hampered by external control such as governmental interference. BLACK’S LAW DICTIONARY 735 (8th ed. 2004).

17. See, e.g., Mark Pettit, Jr., *Freedom, Freedom of Contract, and the “Rise and Fall”*, 79 B.U. L. REV. 263, 289 (1999).

18. See Thomas W. Waelde & James L. Gunderson, *Legislative Reform in Transition Economies: Western Transplants: A Short-Cut to Social Market Economy Status?*, 43 INT’L & COMP. L.Q. 347, 347 (1994) (discussing legal reform in transition economies).

19. Jiang Ping et al., *Lun Xin Hetongfa zhongde Hetong Ziyou Yuanze yu Chengshi Xinyong Yuanze* [On the Principles of Freedom of Contract and Good Faith in the New Contract Law], 1 TRIB. POL. SCI. & L. 2, 4 (1999).

20. See, e.g., Wang Liming & Xu Chuanxi, *Fundamental Principles of China’s Contract Law*, 13 COLUM. J. ASIAN L. 1, 2 (1999).

21. Jiang Ping et al., *Shichang Jingji he Yisi Zizhi* [Market Economy and Autonomy of Will], 6 CASS J.L. 20, 20–25 (1993) (quoted by Wang Liming & Xu Chuanxi, *Fundamental Principles of China’s Contract Law*, 13 COLUM. J. ASIAN L. 1, 12 (1999)). The authors indicate that to accord parties freedom of action to the greatest extent possible is the common demand by the market economy and the autonomy of the parties’ free will. See also, ANTHONY T. KRONMAN & RICHARD A. POSNER, *THE ECONOMICS OF CONTRACT LAW* 1–2 (1979).

22. See, e.g., Li Yongjun, *Cong Qiyue Ziyou Yuanze de Jichu Kan Qi zai Xiandai Hetongfa Shangde Diwei* [On the Status of Contract Freedom in Modern Contract Laws from the Viewpoint of its Foundation], 4 J. COMP. L. 1, 4–5 (2002).

23. See, e.g., Yulie Foka-Kavalieraki & Aristides N. Hatzis, *The Foundations of A Market Economy: Contract, Consent, Coercion*, 8 EUR. VIEW 29, 29 (2009).

absence of coercion and information asymmetry.<sup>24</sup> The more developed and widespread the various contractual relationship, the more dynamic the market economy.

### 3. The Definition and Incidence of “Freedom of Contract” in Current Contract Law of China

#### *a. The Chinese Version of “Freedom of Contract”*

China’s contract laws have never explicitly recognized the principle of “freedom of contract,” and in fact this principle underwent intense debate during the drafting of the Contract Law.<sup>25</sup> As a compromise, the Contract Law adopted the notion of “freedom of contract” in the form of a bundle of principles with some checks and balances.<sup>26</sup>

In China, the meaning of “freedom of contract” still remains somewhat vague. This article agrees with certain scholars that “freedom of contract” should be reflected in all aspects of China’s contract law. The principle of “freedom of contract” is partially reflected in several articles of the Contract Law. The principle of equality serves as the basis of “freedom of contract.”<sup>27</sup> Article 4 of the Contract Law provides the principle of voluntariness that embodies the core of “freedom of contract,”<sup>28</sup> whereas Article 8 of the Contract Law stipulates the legal consequences of the exercise of the freedom of contract and affirms the binding character of

24. See generally Eric A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure?*, 112 *YALE L.J.* 829, 853 (2003); Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 *U. COLO. L. REV.* 683, 716 (1986).

25. For a commentary about the debate, see Jiang Ping et al., *Lun Xin Hetongfa zhongde Hetong Ziyou Yuanze yu Chengshi Xinyong Yuanze* [On the Principles of Freedom of Contract and Good Faith in the New Contract Law], 1 *TRIB. POL. SCI. & L.* 2, 3–5 (1999).

26. The major concern in adopting “freedom of contract” was that it might be abused by the large enterprises to bully the small enterprises, which would disrupt the economic order. As a result, a compromising version of “freedom of contract” was adopted by the Contract Law. Wang Liming, *supra* note 20, at 11. In addition, “freedom of contract” is largely seen as a Western notice, the difficulty in transplanting this notion might be another concern.

27. Contract Law of the People’s Republic of China [Contracts; Enterprises with Foreign Investment] (promulgated by the Second Session of the Ninth National People’s Congress, Mar. 15, 1999, effective Oct. 1, 1999) Nat’l People’s Congress, Mar. 15, 1999, art. 3 (China), available at <http://www.csrc.gov.cn/n575458/n4001948/n4002075/n4002315/4060252.html> (last visited Oct. 11, 2010) (providing that the parties to the contract have equal legal status, and neither party may impose its will on the other) [hereinafter Contract Law of the People’s Republic of China].

28. *Id.* art. 4 (indicating that the parties shall, pursuant to law, have the right to enter into a contract on their own free will, and no unit or person may unlawfully interfere).

contract.<sup>29</sup> Moreover, “freedom of contract” also means that parties should have the autonomy in negotiating and deciding the content of the contract. Article 124 of the Contract Law has provided this autonomy to the contractual parties.<sup>30</sup> At the same time, the Contract Law also imposes limitations on “freedom of contract” in order to prevent its abuses and for the state to regulate the economy and maintain public order.<sup>31</sup> Noticeably, the Contract Law contains provisions that recognize the limited role of the state plan and governmental supervision of contracts.<sup>32</sup>

*b. The Emphasis When Implementing Freedom of Contract in Different Stages of Contracting*

“Freedom of contract” should be reflected in all aspects of China’s contract law, from formation through remedies for breach of contract.<sup>33</sup> In particular, the parties should enjoy the freedom to decide whether or not to enter into a contract and with whom to make a contract, and decide the form and content of the contract without unjustifiable interference by governmental and administrative organizations. Moreover, when interpreting contracts, judges should honor the contractual parties’ original intentions.<sup>34</sup>

*B. Comments on the Rise and Fall of Freedom of Contract in Western Legal Thoughts*

The most complex part of “freedom of contract” lies in balancing the tension between contractual freedom and governmental regulations. As insightfully pointed out by Professor John C. Reitz, although all legal systems have some form of governmental regulation, the degree to which a country is averse to governmental regulation varies from country to country, even among the countries in the western world. Particularly, the U.S. aversion to regulation is not shared as deeply by most other western

---

29. *Id.* art. 8 (indicating that a legally executed contract has legal binding force on the parties. The parties shall fulfill their obligations as contracted, and may not arbitrarily modify or terminate the contract. A legally executed contract is protected by law.).

30. *Id.* art. 124 (providing that where there is no express provision in the Specific Provisions thereof or any other law concerning a certain contract, the provisions in the General Principles thereof apply, and reference may be made to the provisions in the Specific Provisions thereof or any other law applicable to a contract which is most similar to such contract).

31. These limitations will be discussed in detail in *infra* Part VI.B.1.

32. BING LING, *CONTRACT LAW IN CHINA* 9 (Sweet & Maxwell Asia, 2002).

33. Wang Liming, *An Inquiry into Several Difficult Problems in Enacting China’s Uniform Contract Law*, 8 PAC. RIM L. & POL’Y J. 351, 356–57 (1999).

34. *See id.*

countries. In reality, certain European countries are more disposed to limit “freedom of contract” than in the United States.<sup>35</sup> By tracing the history and discussion of Maine’s famous dictum that the progress of the law has been from status to contract,<sup>36</sup> Professor Morris R. Cohen indicates that the support of Maine’s dictum had its roots in the “general individualistic philosophy that manifested itself in modern religion, metaphysics, psychology, ethics, economics, and political theory.”<sup>37</sup> After the peak of “contractualism”<sup>38</sup> and will theory of contract, “freedom of contract” gradually declined. Many U.S. legal scholars have reconsidered their thinking about the future of “freedom of contract.”<sup>39</sup> Certain scholars argued for broad interference with personal preferences.<sup>40</sup> “Freedom of contract” has been attacked as ignoring the bulky concentration of wealth that distorts market processes and that tramples on the rights of consumers and workers.<sup>41</sup> For instance, the issue of unequal bargaining power, which may result in forced consent, is one of them.<sup>42</sup> In addition, the parties may not realize the “freedom of contract,” achieving the original intentions of the agreement due to the high transaction costs among the parties during the process.<sup>43</sup> Instead of commenting on the rise and fall of “freedom of contract” by generalization, certain scholars suggest that breaking up the concept of “freedom of contract” into more specific meanings may be

---

35. For example, German law subjects standard terms and conditions to greater regulation than U.S. law, *see* John C. Reitz, *Political Economy and Contract Law*, in *NEW FEATURES IN CONTRACT LAW* 247 (Reiner Schulze ed., 2007).

36. Sir Henry Maine said “we may say that the movement of the progressive societies has hitherto been a movement from Status to Contract.” HENRY MAINE, *ANCIENT LAW* 182 (Sir Frederick Pollock ed., 1930), *available at* <http://www.panarchy.org/maine/contract.html> (last visited Oct. 14, 2010).

37. Morris R. Cohen, *The Basics of Contract*, 46 *HARV. L. REV.* 553, 558 (1932).

38. *See id.* (defining “contractualism” as the view that in an ideally desirable system of law all obligations would arise only out of the will of the individual contracting freely, rests not only on the will theory of contract but also on the political doctrine that all restraint is evil and that the government is best which governs least).

39. *See, e.g.*, Grant Gilmore, *Introduction to Havighurst's Limitations upon Freedom of Contract*, 1979 *ARIZ. ST. L.J.* 165, 166 (1979).

40. *See, e.g.*, MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870–1960: THE CRISIS OF LEGAL ORTHODOXY* 33–63 (1992).

41. RICHARD A. EPSTEIN, *CONTRACTS SMALL AND CONTRACT LARGE: CONTRACT LAW THROUGH THE LENS OF LAISSEZ-FAIRE*, in *THE FALL AND RISE OF FREEDOM OF CONTRACT* 1 (F.H. Buckley ed., 1999).

42. It is hard for the contract terms to truly reflect the consent of a party with little bargaining power. *See, e.g.*, Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 *HARV. L. REV.* 1173, 1175 (1983).

43. EPSTEIN, *supra* note 41, at 15.



helpful in identifying particular trends that more accurately reflect the directions taken by the government.<sup>44</sup>

However, certain scholars observed that contract law is moving towards a period of “new formalism,”<sup>45</sup> where sophisticated parties are held to a more stringent set of rules vis-à-vis non-sophisticated parties. Following that approach, once a contractual party is labeled as sophisticated, certain presumptions will be imposed automatically, such as the person has relevant experience and knowledge. As a result, those presumptions really cut against those people being labeled as sophisticated.<sup>46</sup> Paradoxically, this trend, from contract to status (namely, sophisticated or not),<sup>47</sup> in reality moves in the opposite direction of what Maine has depicted. However, “freedom of contract” has been working differently in China and moves along a special evolution path accordingly.<sup>48</sup>

### III. A COMPARISON OF THE RATIONALES BEHIND U.S. AND CHINA’S CONTRACT LAWS

This article will now compare the U.S. and China’s contract laws in general works to spot the current tensions and problems in China’s contract laws. It is interesting to notice that it seems the U.S. and China’s contract law systems are confronted by *prima facie* “similar” problems, dilemmas, and intractable tensions. However, China is still at the stage as Deng Xiaoping’s widely quoted phrase “crossing the river by groping for stones,” and thus the problems encountered by the two countries might be intrinsically different in nature. Analyzing the tensions in the ideological and institutional settings, in which contract laws are embedded, might generate insightful suggestions for both countries.

#### A. Ideological Level: Paternalism v. Contractualism

Although the term “paternalism” has various meanings and definitions,<sup>49</sup> in general, any legal rule that prohibits an action on the

---

44. See, e.g., Mark Pettit, Jr., *Freedom, Freedom of Contract, and the “Rise and Fall”*, 79 B.U.L. REV. 263, 271 (1999).

45. See, e.g., Mark Movsesian, *Two Cheers for Freedom of Contract*, 23 CARDOZO L. REV. 1529, 1530 (2002).

46. See, e.g., Meredith R. Miller, *Contract Law, Party Sophistication and the New Formalism*, 75 MO. L. REV. 493, 493 (2010). Moreover, what is problematic is that “sophisticated” is not well defined.

47. “Sophistication” is certainly a significant indicia of one’s socioeconomic status.

48. See *infra* Part V.

49. GERALD DWORNIK, PATERNALISM: SOME SECOND THOUGHTS, IN PATERNALISM 19 (Rolf Sartorius ed., 1983); Joel Feinberg, *Legal Paternalism*, 1 CANADIAN J. OF PHIL. 105, 105 (1971).

ground that it would be contrary to the actor's own welfare is paternalistic in nature.<sup>50</sup> Paternalistic interventions may be classified according to various parameters.<sup>51</sup> The censure of paternalism within contract law directly follows from the individualistic conceptions underlying the principle of "freedom of contract." On the other hand, there are justifications for paternalism, and numerous rules and doctrines ground, at least partly, in paternalism.<sup>52</sup> Some instances of paternalism in contract law do not entail a rejection of private autonomy, but may rather be viewed as enhancing free will.<sup>53</sup>

Accordingly, the role of state may vary in different situations and times, based upon the ideological background. In different contexts, the state may act as a director,<sup>54</sup> a gate-keeper,<sup>55</sup> or even an ad hoc contractual party, each with different implications for the contracting party. The role of the state in contracts and contract law is no exception. Generally speaking, with respect to the contract law (being one of the most important instruments to facilitate transactions in a market economy), the state should leave sufficient room for the contractual individuals. Only when public goods and services are concerned, or when a market fails, should the state jump in as the gate-keeper in order to keep the economy from falling apart.<sup>56</sup> The debates and discussions in the United States provide China with insights and reference. However, given the different social and

---

50. Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 763 (1983).

51. Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 236 (1998).

52. See Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 765 (1983) (finding that there are different plausible justifications for one particular group or class of paternalistic restriction in the contract law: consideration of economic efficiency, distributive justice, personal integrity, to name a few). See also Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1785 (1997).

53. For example, intervening with the freedom of people who are unable to make rational decision due to their young age.

54. The Shanxi provincial government's role in the coal mining reform is an example. For a detailed discussion about Shanxi coal mining reform, see *supra* Part III.A.

55. Chinese law requires several types of contracts to be approved by the government. These contracts usually concern important public interests, and governmental examination and approval are necessary before the agreement of the parties may become legally effective. Chinese-foreign joint venture contracts, Chinese-foreign petroleum exploitation contracts, and contracts for the import of technology are some major examples of contracts requiring government approval.

56. See generally ROBERT B. SEIDMAN, CONTRACT LAW, THE FREE MARKET, AND STATE INTERVENTION: A JURISPRUDENTIAL PERSPECTIVE, IN STATE, SOC. & CORP. POWER 17 (Marc R. Tool & Warren J. Samuels eds., 1989); Andreas Maurer, *Consumer Protection and Social Models of Continental and Anglo-American Contract Law and the Transnational Outlook*, 14 IND. J. GLOBAL LEGAL STUD. 353, 353-54 (2007).

economic infrastructure, it is always advisable to bear in mind that what works in the United States might come out differently in China.<sup>57</sup> Moreover, it is important to bear in mind that the state doesn't necessarily know the interests of individual citizens better than the citizens know themselves.<sup>58</sup>

### *B. Institutional Level: Rules v. Standards*

The development of legal infrastructure is the means through which to achieve economic development.<sup>59</sup> Generally speaking, there are two opposing models for developing legal solutions to substantive problems. One formal model favors the use of clearly defined, highly administrable, general rules, and the other supports the use of equitable standards producing ad hoc decisions with relatively little precedential value.<sup>60</sup>

A "rule" would specify in advance the conduct to which it is applied, while a "standard" merely provides general guidance without specifying the precise details of the conduct required.<sup>61</sup> There are always tensions between using rules or standards.<sup>62</sup>

Judge Richard A. Posner insightfully recognizes the fundamental tradeoff between making an investment in developing rules and in training the judiciary.<sup>63</sup> Accordingly, he argues that enacting comprehensive rules

---

57. See, e.g., Donald Clarke, *Lost in Translation? Corporate Legal Transplants in China 2* (The George Wash. Univ. Law School Pub. Law and Legal Theory Working Paper No. 213, 2006), available at <http://ssrn.com/abstract=913784> (last visited Oct. 16, 2010) (borrowing foreign norms and institutions in a time of rapid social change where the home culture is lagging behind is one of the reasons explaining why it is often difficult for transplanted legal norms to fit well).

58. See, e.g., Sun Xuezhong, *Qiyue Ziyou, Qiyue Ziyouquan yu Qiyue Quanli* [*Freedom of Contract, Right of Freedom of Contract and Contractual Rights*], 46 JILIN UNIV. J. SOC. SCI. 13, 16 (2006).

59. See, e.g., Tom Ginsburg, *Does Law Matter for Economic Development?: Evidence from East Asia*, 34 LAW & SOC'Y REV. 829, 836 (2000) (discussing that there has been rich scholarship on the relationship between legal infrastructure and economic development); Daniel M. Klerman, *Legal Infrastructure, Judicial Independence, and Economic Development*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 427, 427, 434 (2007).

60. See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1975).

61. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 557 (1992).

62. See LOUIS KAPLOW, GENERAL CHARACTERISTICS OF RULES, IN ENCYCLOPEDIA OF LAW AND ECONOMICS 9–10 (Boudewijn Bouckaert & Gerrit De Geest eds., 1998) (introducing the rules versus standards). See also Kaplow, *supra* note 61, at 557.

63. Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13 WORLD BANK RES. OBSERVER 1, 1 (1998).

is more efficient than cultivating a sophisticated judiciary for a developing nation.<sup>64</sup>

Based upon comparison between U.S. and China's contract law and the jurisprudence, comprehensive institutional reform in China should be carried out systematically and holistically, rather than devising discrete solutions to particular problems. The entire system should be evaluated as a whole in order to ensure that the economic, legal and social goals of the society are fulfilled. Specifically, in the realm of laws regulating contracts, other laws shall be adopted in addition to judicial interpretation.<sup>65</sup>

## VI. LIMITATIONS ON THE "FREEDOM OF CONTRACT"

Governmental intervention limiting "freedom of contract" can take various forms: generating rules prohibiting certain types of agreements, supervising certain types of agreements, and deciding whether or not to enforce certain agreements, among others.

### *A. A Preliminary but Fundamental Issue*

Before diving into the discussion about the limitations on the "freedom of contract," it is worth noticing that while the government has been emphasizing "freedom of contract" in the contract law, there are still certain instances where the government dominates. The relevant question here is what are the areas where governmental intervention is justified, or even necessary, and thus are immune from "freedom of contract?" In other words, what are the areas, if any, that "freedom of contract" is inapplicable?

The Shanxi coal mining reform is a case on point here. The government of Shanxi Province has, in accordance with certain governmental regulations and policies,<sup>66</sup> pushed for the implementation of the coal mine mergers and acquisitions. Certain people viewed this as a reform because the state-owned companies were able to benefit at the expense of the private sector. During this transformation, if the coal bosses did not accept the plan proposed by the government, their coal mines would be forced to shut down. This is part of the Chinese government's efforts to consolidate the coal industry to improve production efficiency and reduce coal mine accidents. In search for a reasonable balance between public and

---

64. *See id.*

65. Examples include (but are not limited to) those laws guaranteeing consumer sovereignty, laws safeguarding fair competition, and laws regulating employment related contracts.

66. *Views on Implementing Acceleration of the Reorganization and Merger of Coal Enterprises*, <http://www.shanxigov.cn/n16/n1116/n1458/n1518/n34105/6955367.html> (last visited October 29, 2010).

non-public economy, as well as the balance between national concerns and various interest groups' pressure, the government dominated the entire process of forced mergers where the small coal mines have been merged into one of the seven state-owned coal mines designated by the government. Moreover, instead of being a result of free negotiation and bargain, the amount of the consideration in those mergers and acquisitions are determined by the government. Apparently, the approach is at odds with "freedom of contract." On the other hand, given the complexity of the intertwined issues involved (such as environmental protection related issues, the public interests of the region, the production safety, and the coal industry policies), it is plausible that the governmental intervention is justified. However, the key is *how* the government should implement the plan. Looking back, the government's approach in this reform could be improved by relying more on the market mechanism as opposed to the governmental planning. For example, the small coal mining bosses should be given certain time to adjust their business through their voluntary strategic alliances and those who are able to meet the governmentally imposed criteria after adjustment should survive. Moreover, those small coal mining bosses should be given more options in selecting their mergers and acquisitions partners as well as other aspects of the mergers and acquisitions.

### *B. Overarching Limitations on "Freedom of Contract"*

The principle of "good faith" and the obligation not to offend public order and good morals serve as the two overarching limitations on "freedom of contract." These two principles are applicable to all types of contracts and in every stage of the contractual process.

#### 1. The Obligation to Act in Good Faith

As an overarching limitation on "freedom of contract," the principle of "good faith"<sup>67</sup> requires the contractual parties to act faithfully to the agreed

---

67. The contour and meaning of "good faith" may vary with the legal system and context. As a result, defining "good faith" is a formidable task. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1979) made a nice try in defining "good faith" (finding that good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.).

purpose of the contract.<sup>68</sup> In fact, this principle has been reflected throughout the entire Contract Law.<sup>69</sup> In the Contract Law, Article 6<sup>70</sup> requires the parties observe the principle of honesty and good faith in exercising their rights and performing their obligations. In addition, Article 42<sup>71</sup> makes it clear that the party shall be liable for damage if the party negotiated a contract in bad faith<sup>72</sup> and consequently caused losses to the other party.<sup>73</sup> Furthermore, Article 60<sup>74</sup> requires the parties abide by the principle of good faith and perform various obligations in accordance with the nature and purpose of the contract and the transaction custom. Additionally, Article 92<sup>75</sup> stipulates that after the termination of the rights and obligations under the contract, the parties shall observe the principle of honesty and good faith and perform various obligations pursuant to relevant transaction custom. Moreover, the principle of “good faith” could also kick in where anticipatory breach occurs. Article 108<sup>76</sup> indicates that where one party to a contract expresses explicitly or indicates through its acts that it will not perform the contract, the other party may demand it to bear the liability for the breach of contract before the expiration of the performance period. However, “good faith” prevents one from stopping the performance of one’s duty just because of the other party’s minor noncompliance.<sup>77</sup>

---

68. For a general discussion about the evolution of the principle of good faith as well as its reflection in China’s contract law, see Chen Nianbing, *Shilun Hetongfa Zhong De Chengshi Xinyong Yuanze* [On the Bona Fide Doctrine in the Contract Law], 6 LEGAL SCI. 59 (2003).

69. See Wang Liming & Xu Chuanxi, *Fundamental Principles of China’s Contract Law*, 13 COLUM. J. ASIAN L. 1, 7–9 (1999) (discussing, in general, the good faith principle as it applies in China).

70. Contract Law of the People’s Republic of China, art. 6.

71. Contract Law of the People’s Republic of China, art. 42.

72. The “excluder” approach suggested by Professor Robert S. Summers might be a good prototype for China in applying the principle of “good faith:” “good faith” essentially excludes certain types of conduct characterized as “bad faith” because “bad faith” is relatively easier to define. See Robert S. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195, 196 (1968); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 812 (1982).

73. Similar to the doctrine of *culpa in contrahendo*. See Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401, 401, 446–47 (1964).

74. Contract Law of the People’s Republic of China, art. 60.

75. Contract Law of the People’s Republic of China, art. 92.

76. Contract Law of the People’s Republic of China, art. 108.

77. For example, A and B entered into a contract where B is going to supply goods to A, while A is supposed to pay \$1 million USD to B, and A told B that he had a gap of \$500 USD. Can B then cancel the contract? Probably not; the legal basis here lies in the principle of “good faith.”

Moreover, Article 125<sup>78</sup> imposes the “good faith” obligation when interpreting disputed clauses of the contract. Although it is acknowledged “good faith” can cure some ills of “freedom of contract,” there are some inherent limitations related to it.<sup>79</sup> Furthermore, it will impose significant demand on the judiciary’s capability in interpreting contracts.

## 2. The Obligation Not to Offend Public Order and Good Morals

Another principal check on “freedom of contract” is the requirement not to offend public order (examples of contracts that offend public order include contracts for tax evasion, unfair competition, profiteering, and gambling) and good morals (examples of contracts that offend good morals include contracts that are immoral such as sale of human organs), contracts for servitude, bad faith behavior (such as entering into contracts by taking advantage of one’s financial difficulties, and prenuptial agreement). Some scholars argue that the requirement not to offend public order and good morals is a way to correct the “freedom of contract” so as to truly reflect the real freedom of the contracting parties.<sup>80</sup> This requirement has been reflected in the General Principles of Civil Law<sup>81</sup> as well as various other specific laws and regulations.<sup>82</sup> Accordingly, one caveat is worth mentioning here. The judiciary should be cautious so as not to overreact when there are potential offenses of public order or good morals, as going beyond the limit is as bad as falling short.<sup>83</sup>

---

78. Contract Law of the People’s Republic of China, art. 125.

79. Zhang Suhua, *Chengshi Xinyong Yuanze dui Qiyue Ziyou Yuanze de Xianzhi* [*The Principle of Good Faith’s Limitation on Freedom of Contract*], 4 LAW SCI. MAG. 17, 18–19 (1999).

80. See, e.g., Feng Zhongming, *Hetong Ziyou yu Gongxu Liangsu* [*Freedom of Contract and Public Order and Kind Custom*], 17 J. OF YUNNAN UNIV. LAW ED. 73, 75 (2004).

81. General Principles of the Civil Law of the People’s Republic of China (promulgated by the Fourth Session of the Sixth National People’s Congress, Apr. 12, 1986, effective Jan. 1, 1987) Nat’l People’s Congress, Apr. 12, 1986, art. 7 (China) (indicating that civil activities shall have respect for social ethics and shall not harm the public interest, undermine state economic plans, or disrupt social economic order).

82. See, e.g., Zhao Wanyi & Wu Xiaofeng, *Qiyue Ziyou yu Gongxu Liangsu* [*Freedom of Contract and Public Order and Kind Custom*], 25 MODERN LAW SCI. 52, 57–58 (2003).

83. For example, in 2001, a court in China invalidated a will simply because the legatee is the mistress of the decedent. This seems an egregious infringement on the party’s autonomy. Here, the court overreacted, at least in my opinion.

### C. Various Specific Limitations on "Freedom of Contract"

In addition to the overall limitations on "freedom of contract," there are a few specific limitations that only apply to certain types of contractual relationships in some settings.

#### 1. Administrative Approval and Supervision

Chinese laws require several types of contracts to be approved by the government. These contracts usually concern important public interests, and governmental examination and approval are necessary before the agreement of the parties may become legally effective.<sup>84</sup>

Moreover, the Contract Law entitles administrative authorities to supervise all illegal activities by voiding contracts that have harmed the interests of the state and the public.<sup>85</sup> This suggests that administrative authorities shall determine whether a contract has harmed the interests of the state, the collective or the third party. For certain types of contracts/projects, such as those contracts where state assets are involved and infrastructure project construction contracts,<sup>86</sup> it is necessary to have certain supervision.<sup>87</sup> Moreover, government needs to guard against those "contracts" that are an attempt to conceal illegal goals under the disguise of legitimate forms as well as those contracts that harm social and public interest.<sup>88</sup> However, it is critical to ascertain the appropriate reaches of the administrative supervision. This issue needs to be further addressed through law, regulation, or the Supreme People's Court's interpretation to ensure that the administrative interference is strictly limited within the

---

84. For example, Sino-foreign joint venture contracts need governmental approval to become legally effective.

85. Contract Law of the People's Republic of China, art. 127. The departments of administration for industry and commerce and other relevant administrative authorities are, within their respective jurisdictions, in charge of supervising and handling illegal acts whereby a contract is used to harm the state or public interests.

86. Ruan Zanlin & Jin Qizhou, *Hetong Xingzheng Jianguan de Xinsikao* [A New Speculative Research on the Administrative Supervision and Control over Contracts], 22 MODERN LAW SCI. 122, 123 (2000).

87. See ADMINISTRATION FOR INDUSTRY & COMMERCE, ZUOHAO HETONG XINGZHENG JIANGUAN GONGZUO, YI SHIJI XINGDONG LUOSHI QUANGUO GONGSHANG GONGZUO HUIYI YAOQIU [PROPERLY CONDUCT THE ADMINISTRATIVE SUPERVISION OF CONTRACTS TO IMPLEMENT THE REQUIREMENTS RAISED IN THE NATIONAL INDUSTRY & COMMERCE CONFERENCE BY PRACTICE] 29-30 (2003).

88. See Contract Law of the People's Republic of China, art. 52.



appropriate boundaries.<sup>89</sup> In addition, the state plan contemplated by Article 38 of the Contract law might affect the parties' contract-making power.<sup>90</sup>

## 2. Special Care for Vulnerable Parties

Similar to other countries, the urgent need to protect the weak parties in contractual relationships<sup>91</sup> is another significant challenge for China's contract law and legal system.

Modern economic activities are characterized by the widespread use of standard terms. While standard terms generally expedite the formation of contracts and promote economic efficiency, monopolistic entities and other economically advantaged parties tend to use standard terms as a means of imposing unconscionable or unfair, contractual terms on consumers and other weaker parties. In China, the function of standard form contract in earlier times was quite different from those in western countries at that time.<sup>92</sup> In more recent years, standard terms have been widely used in those industries that are monopolized by the government or state-owned enterprises or are heavily regulated, such as banking, public transportation, and public utilities. The potential harm that standard contracts may impose on a consumer is addressed by several provisions. For instance, the Contract Law requires the party who provides a standard contract form to explain the terms and draw the other party's attention to the exclusion/restriction of liability.<sup>93</sup> Moreover, the Contract law embraces the Chinese version of "contra proferentem rule,"<sup>94</sup> whereby Article 41<sup>95</sup> of the Contract Law stipulates that if a dispute arises over the understanding of

---

89. See Mo Zhang, *Freedom of Contract with Chinese Legal Characteristics: A Closer Look at China's New Contract Law*, 14 TEMP. INT'L & COMP. L.J. 237, 248–49 (2000).

90. Contract Law of the People's Republic of China, art. 38. This article provides that where the state has issued a mandatory plan or a state purchasing order based on necessity, the relevant legal persons and the other organizations shall conclude a contract between them in accordance with the rights and obligations as stipulated by the relevant laws and administrative regulations.

91. See generally ROBERT HALE, *FREEDOM THROUGH LAW: PUBLIC CONTROL OF PRIVATE GOVERNING POWER* (1952).

92. In China, standard terms and standard contracts were once used as a means of enforcing mandatory state plans. Standard terms were imposed by the government and reflected the requirements of state plans from which the parties could not derogate. See also *supra* Part II.

93. Contract Law of the People's Republic of China, art. 39.

94. See PÉTER CSERNE, *POLICY CONSIDERATIONS, IN CONTRACT INTERPRETATION: THE CONTRA PROFERENTEM RULE FROM A COMPARATIVE LAW AND ECONOMICS PERSPECTIVE*, IN *CONTRACT THEORY—CORPORATE LAW 66* (Gavvala Radhika ed., 2009) (showing a comparative overview of the rule).

95. Contract Law of the People's Republic of China, art. 41.

a standard clause, and the standard clause has more than one interpretation, the clause shall be interpreted in a manner unfavorable to the party providing the clause. In addition, if a standard clause is inconsistent with the non-standard clause, the non-standard clause shall be adopted.

In addition to the Contract Law, the Law of the People's Republic of China on Protection of Consumer Rights and Interests is another powerful weapon for the consumers in China.<sup>96</sup> However, *how* a consumer rights protection law regulates economic behavior is also important. Here, the "corkage fee" dispute provides a neat example to examine what is the reasonable boundary of governmental intervention through rule making and *how* the rule making process should be. As a common business practice in certain areas (such as Guizhou) of China, certain restaurants charge a corkage fee. As a reaction, the Guizhou Consumer Protection Regulation was enacted and the regulation expressly prohibits restaurants from charging corkage fees.<sup>97</sup> Clearly, this is the legislature's intervention aiming to protect consumers. If those restaurants have given consumers enough advanced notice with respect to the corkage fee, it seems that consumers enjoy absolute freedom to decide which restaurant they will go to, whether those restaurants which charge corkage fees or those that do not charge such fees. However, given that the corkage fee practice has been formalized as trade usage among the restaurant business, in reality consumers do not have much "freedom" to choose which restaurant to dine. As a result, legislature's intervention by rule making seems opportune under the circumstance. However, it seems that blanket prohibition of corkage fees is somewhat arbitrary. As a result, it might be advisable to have representatives of the consumer protection association, as well as the restaurant business association, participate in the rule making process in formulating the regulation.

Likewise, in other situations where there is disparity with respect to bargaining power (*e.g.*, landlord-tenant, employer-employee), special laws or provisions are needed to regulate these special contractual

---

96. Law of the People's Republic of China on Protection of Consumer Rights and Interests (promulgated by the Fourth Meeting of the Standing Committee of the Eighth National People's Congress, Oct. 31, 1993, effective Jan. 1, 1994) Nat'l People's Congress, Oct. 31, 1993, art. 24 (China), available at <http://fj.baic.gov.cn/shunyi/detail.asp?ID=1560> (last visited Oct. 14, 2010) (prohibiting business operators from making rules that are unfair to the consumers through standard contracts and excluding civil liability for their infringement of the consumers' rights).

97. See Consumer Protection Regulation of Guizhou Province (Nov. 24, 2006, effective Feb. 1, 2007), art. 29 (China), available at [http://www.chinacourt.org/flwk/show1.php?file\\_id=115806](http://www.chinacourt.org/flwk/show1.php?file_id=115806) (last visited Oct. 16, 2010).

relationships.<sup>98</sup> For instance, to better protect the lawful rights of workers, China issued its first nationwide labor contract law on June 29, 2007, which took effect on January 1, 2008.<sup>99</sup> Even though it seems that the said labor contract law already significantly strengthens the employees' rights, much more needs to be improved to better safeguard those rights. For instance, the labor union should be empowered more to act for the employees.

Another area relating to the protection of vulnerable parties is the regulation of unconscionable contracts. Article 54<sup>100</sup> of the Contract Law provides that a contract is voidable if it is evidently unfair at the time of the conclusion of the contract. The rationale is to prevent the advantageous party who possesses more information from bullying the weak party through certain kinds of coercion.<sup>101</sup>

#### V. OTHER OPTIONS FOR CONTRACT LAW

An institutional analysis might offer additional insights.<sup>102</sup> Echoing the balance between efficiency and equity, when considering freedom of contract in China, it is not only helpful but also necessary to study the informal institutions, which intertwine with the legal infrastructure. The development of commercial law is an excellent example here. When doing complex multi-jurisdictional deals, international law firms work closely with their clients, and help them in entering into various contracts. The content of those contracts will reflect those business customs, which is a type of informal institution. If there are any disputes, arbitration or other dispute settlement mechanisms will also help institutionalizing those business customs. Again and again, those business customs gradually become widely-accepted commercial laws. The evolution and development of commercial laws reflects the significance of informal institutions. In fact, relational contract theory has reworked the contract law theory by

---

98. See Lu Wendao, *Shilun Qiyue Ziyou Ji Lifa Ganyu* [Discussion on Freedom of Contract and Legislative Intervention], 91 NANJING SOC. SCI. 57, 59–60, 62 (1996).

99. See, e.g., Li Jing, *China's New Labor Contract Law and Protection of Workers*, 32 FORDHAM INT'L L.J. 1083, 1084–85 (2009) (discussing the labor conditions in China and how the new labor contract law responds to the address the labor problems to better protect the workers' rights and interest).

100. Contract Law of the People's Republic of China, art. 54.

101. An example of nullifying a contract by a court is Huang Haiyan v. Beijing Hansen Cosmetology Co. Ltd., Nov. 16, 2005, at 12–13 (Beijing Chaoyang Dist. People's Ct., 2005) (discussing that the franchiser's misrepresentation rendered the contract unfair).

102. See, e.g., DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 1, 36, 46 (1990) (finding that the idea that a society's formal and informal institutions contribute to relationships and transactions, and vary from culture to culture); Douglass C. North, *Institutions*, 5 J. ECON. PERSP. 97, 97 (1991).

analyzing contracts embedded in a matrix of social relations and the understanding of the essential elements of the contextual relations.<sup>103</sup> Moreover, the beauty of relational contract theory lies in its capability to theorize exchanges at the abstract level while also to contextualize in examining the specific types of relations, including those contractual relations between sophisticated commercial parties of relative equality as well as those relations between parties of inequality or hierarchy.<sup>104</sup>

Any analysis of the impact of the law on Chinese economic development must take into consideration the extent to which laws can perform well only when they are generated within appropriate social contexts.<sup>105</sup> Among the literature in this area, the discussions between Janet Tai Landa and John K.M. Ohnesorge are particularly thought-provoking. By taking other informal, yet essential institutional factors into account, Janet Tai Landa argues that it is not easy for westerners to understand the Chinese way of doing business because instead of relying on formal contracts, the Chinese place great emphasis on the importance of *guanxi* (*i.e.* personal relationships) and trust in their business dealings with fellow Chinese.<sup>106</sup> Interestingly, this may not be peculiar to China. In particular, some authors suggest that the role of law is different between “liberal market economies” and “coordinated market economies” for similar reasons.<sup>107</sup> In addition, Professor Landa shows that it is possible to understand the Chinese preference for informal or extra-legal *guanxi* way of doing business as an efficient system of contracting under conditions of contract uncertainty.<sup>108</sup> Professor Ohnesorge recognized that the

---

103. See Ian MacNeil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 880, 891 (2000). See also Paul Gudel, *Relational Contract Theory and the Concept of Exchange*, 46 BUFF. L. REV. 763, 777 (1998).

104. See Jay M. Feinman, *The Insurance Relationship as Relational Contract and the “Fairly Debatable” Rule for First-Party Bad Faith*, 46 SAN DIEGO L. REV. 553, 556–57 (2009).

105. See WILLIAM ALFORD, *THE MORE LAW, THE MORE...? MEASURING LEGAL REFORM IN THE PEOPLE’S REPUBLIC OF CHINA, IN HOW FAR ACROSS THE RIVER? CHINESE POLICY REFORM AT THE MILLENNIUM* 122 (Nicholas C. Hope et al. ed., 2003).

106. JANET TAI LANDA, *COASEAN FOUNDATIONS OF A UNIFIED THEORY OF WESTERN AND CHINESE CONTRACTUAL PRACTICES AND ECONOMIC ORGANISATIONS, IN RULES AND NETWORKS: THE LEGAL CULTURE OF GLOBAL BUSINESS TRANSACTIONS* 347 (Richard P. Appelbaum, William L.F. Felstiner & Volkmar Gessner ed., 2001). See also PITMAN B. POTTER, *GUANXI AND THE PRC LEGAL SYSTEM: FROM CONTRADICTION TO COMPLEMENTARITY, IN SOCIAL CONNECTION IN CHINA: INSTITUTIONS, CULTURE, AND THE CHANGING NATURE OF GUANXI* 179 (Thomas Gold, Doug Guthrie & David Wank eds., 2002); Ethan J. Leib, *Friendship & the Law*, 54 UCLA L. REV. 631, 659 (2007).

107. See KATHARINA PISTOR, *LEGAL GROUND RULES IN COORDINATED AND LIBERAL MARKET ECONOMIES, IN CORPORATE GOVERNANCE IN CONTEXT 2* (Klaus J. Hopt et al., 2005).

108. JANET TAI LANDA, *COASEAN FOUNDATIONS OF A UNIFIED THEORY OF WESTERN AND CHINESE CONTRACTUAL PRACTICES AND ECONOMIC ORGANISATIONS, IN RULES AND NETWORKS: THE*

counterpart of contract law, namely, certain code of ethics shared by members of the relevant ethnic group, build up the infrastructure that maintain the functioning of the ethnically homogeneous middleman group model proposed by Janet Tai Landa.<sup>109</sup> Moreover, in reaction to Professor Landa's assimilation of contract law and other non-legal norms to the "rules of the game," he suggested that there are different ways in which rule structures interact with the playing of a game that warrant further research.<sup>110</sup> From their discussions, people may find potential new room to develop "freedom of contract" in China, namely, by intertwining legal institutions with social institutions. Indeed, a good proportion of the institutional design that has been tested by the market will enable the contractual parties to have greater contractual freedom, and as a result, the market will evolve specific contract types that will more genuinely reflect the parties' desires. However, this article is not suggesting not to develop formal laws and legal institutions, particularly because informal institutions might reinforce social inequalities.<sup>111</sup>

## VI. CONCLUSION

The western notion of "freedom of contract" has provided China with some helpful ideas which might be molded to work properly within the Chinese society. These notions have helped to shape the development of China's contract law in recent years. The Contract Law was an appropriate move towards liberalizing the Chinese economy.<sup>112</sup>

The application of "freedom of contract" requires several assumptions and conditions to be met: adequate information, free competition, and

---

LEGAL CULTURE OF GLOBAL BUSINESS TRANSACTIONS (Richard P. Appelbaum, William L.F. Felstiner & Volkmar Gessner eds., 2001). See also John H. Matheson, *Convergence, Culture and Contract Law in China*, 15 MINN. J. INT'L L. 329, 347, 381 (2006); Philip J. McConaughay, *Rethinking the Role of Law and Contracts in East-West Commercial Relationships*, 41 VA. J. INT'L L. 427, 429 (2001); Patricia Pattison & Daniel Herron, *The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China*, 40 AM. BUS. L.J. 459, 461 (2003).

109. JOHN K.M. OHNESORGE, UNDERSTANDING CHINESE LEGAL AND BUSINESS NORMS: A COMMENT ON JANET TAI LANDA'S CHAPTER, IN RULES AND NETWORKS: THE LEGAL CULTURE OF GLOBAL BUSINESS TRANSACTIONS 372 (Richard P. Appelbaum, William L.F. Felstiner & Volkmar Gessner eds., 2001).

110. *Id.* at 365–79.

111. This part on the interaction between institutions and economic development is based upon communications with Professor John C. Reitz. See also Mark C. Cassona, Marina Della Giusta & Uma S. Kambhampati, *Formal and Informal Institutions and Development*, 38 WORLD DEVELOPMENT 137, 137 (2010).

112. See Zhong Jianhua & Yu Guanghua, *China's Uniform Contract Law: Progress and Problems*, 17 UCLA PAC. BASIN L.J. 1, 9 (1999).

peoples' full rationality. However, these assumptions are at odds with the reality in China. As a result, a modified version of "freedom of contract" with Chinese characteristics might be suitable. Specifically, in the early stages of the maturation of contract laws, certain governmental supervision is necessary because in certain instances where parties are not mature enough to understand the risks they are taking; sometimes Chinese cultural predispositions against placing entire deals in contracts. Moreover, the government always acts in the public interest whereas parties may only act in the interests of their own profits. Nonetheless, legislatures, administrative organizations and courts have to offer strong justifications for its interventions and as well as the limitations on "freedom of contract."

Legal reform is like a comprehensive engineering project that has various dimensions, including both top-down reform (such as those state led rule making efforts) and bottom-up development (such as the evolution from business customs to commercial laws). Moreover, legal reform is a process. In light of China's special concerns, carrying out a government-driven reform might be more efficient than cultivating a sophisticated judiciary. In some aspects of contract law it is more efficient to have some user-friendly rules, as opposed to adopting vague standards.

What is the future of China's contract law? In what aspects could China's contract law be improved? In which way should these reforms of China's contract law be carried out? What should be the interactions with other formal or informal institutions in China? The search for the reasonable boundary between "freedom of contract" and the justifiable limitations is a process.